# INDEX



## STATUTES CITED



## AUTHORITIES CITED



69071—25†—1

# In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 258

GEORGE D. PROVOST AND CORNELIUS W. PROVOST, copartners, composing the firm of Provost Bros. & Company, appellants

*v.*

THE UNITED STATES

*APPEAL FROM THE COURT OF CLAIMS*

## BRIEF FOR THE UNITED STATES

This case below is not yet officially reported The opinion of the court is found in the record beginning on page 12.

### JURISDICTION

The appeal is from the Court of Claims under Section 242 of the Judicial Code. That court, upon findings of fact, by judgment filed December 1, 1924, dismissed the petition of the appellants. (Rec. p. 20.) On December 17, 1924, appellants made application for and gave notice of an appeal to this Court, which appeal was allowed on January 12, 1925. (Rec. p. 20.)

STATEMENT

The appellants' brief sets forth with much detail the facts which may be summarized briefly as follows:

The appellants are members of the New York Stock Exchange and the transactions involved were conducted upon and governed by the rules of that Exchange. They sued the United States to recover the sum of $3,344.76, the value of internal-revenue stamps which they alleged they had been unlawfully required to affix to tickets representing stock borrowed from and returned to members of the Exchange in connection with "short sales" transactions. After making an unsuccessful claim for refund this suit was brought.

The rules of the Exchange require a broker who sells stock in the "regular way" to deliver that stock on the following business day. (Finding VI, R. 6.) When, therefore, a broker sells stock which he does not have for delivery; that is, sells it "short," he obtains the stock from another broker by a process known on the Exchange as "borrowing." When he borrows the stock he pays the lending broker the full market value of the stock and receives the certificate indorsed in blank. The certificate thus received he delivers to the broker to whom he has made the sale, receives the price thereof, and, so far as the original sale is concerned, the transaction is complete.

When he borrows the stock certain obligations arise between him and the lending broker. He may return the stock, or, rather, an equal amount of the

same stock, at any time, and must return it upon demand. If, meanwhile, the price of the stock advances, he must pay to the lending broker in cash the amount of the advance. If, on the contrary, the price of the stock declines, the lending broker returns to him the difference in cash. In the event that a dividend is declared upon the stock before it is returned, the borrowing broker must pay to the lending broker the amount of the dividend; and if, on the other hand, there should be an assessment against the stock the lending broker must pay the assessment.

Sometimes the lending broker pays to the borrowing broker interest upon the money received for the stock, usually at the prevailing rate for call loans. Sometimes the stock is loaned "flat," as it is termed—that is, without interest—and sometimes it is loaned at a "premium"—that is, the borrowing broker pays the lending broker for the use of the stock instead of receiving interest from him. These details, of course, result from the operation of the law of supply and demand, the stock loaning at a premium when the short interest is large; that is, when the demand for stock is urgent; the lending broker paying interest or lending "flat" when the short interest is smaller and the demand for the stock less.

When the borrowing broker wishes to complete the transaction by a return of the stock—that is, to "cover," as it is termed—he buys it in the market and delivers it to the broker from whom he borrowed and receives back his money. In practice, as found

by the Court of Claims, Finding XXVI, page 11, these transactions, in the case of active securities, are cleared through the Stock Exchange Clearing House—that is, these various transactions are evidenced by "sales tickets," "loan tickets," and "borrowed stock returned tickets," which are cleared on balances from the clearing house, and it is to these tickets that the stamps are affixed.

If the broker lending the stock calls the loan before the other broker is in a position to close the transaction by purchase, the latter broker borrows in a similar way stock from another broker and returns it to the broker from whom he borrowed the first stock. This may, of course, happen a number of times. The ordinary case of a short sale, accompanied by a borrowing and a return of the stock, therefore, involves four transactions.

First. The original sale;

Second. The borrowing of the stock to complete it;

Third. The purchase of the stock to "cover"; and

Fourth. The delivery of that stock to the lending broker.

### THE QUESTION

It is not questioned that stamps must be affixed when the borrowed stock is delivered by the borrowing broker to the purchaser to consummate the original sale; or, likewise, when the stock is purchased by the borrowing broker to be returned to the lending broker.

The claim here is that no stamps are necessary upon the slip evidencing the transfer of the stock

from the lending broker to the borrowing broker, nor upon the slip representing the return of the stock to the lending broker by the borrowing broker. The suit relates wholly to stamps canceled in connection with these two transactions, and the question arises under the provisions of Paragraph 4, Schedule A, Title VIII, of the Revenue Act of October 3, 1917, ch. 63, 40 Stat. 300, 322, and also under similar provisions of the Revenue Act of 1918, Act of February 24, 1919, ch. 18, 40 Stat. 1057, 1135. The question whether these stamps were required was submitted by the Secretary of the Treasury to the Attorney General, and was answered in the affirmative by Acting Attorney General John W. Davis, in an opinion dated March 23, 1918, 31 Ops. of the Atty. Gen'l 255. Thereupon, under date of March 30, 1918, Treasury Decision No. 2685, set forth in the second finding, page 5, was promulgated.

THE STATUTE

Act of Oct. 3, 1917, ch. 63, Title VIII, Schedule A, Paragraph 4, 40 Stat. 300, 322

4. Capital stock, sales, or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock in any association, company, or corporation, whether made upon or shown by the books of the association, company, or corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the

benefit of such stock or not, on each $100 of face value or fraction thereof, 2 cents, and where such shares of stock are without par value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share, unless the actual value thereof is in excess of $100 per share, in which case the tax shall be 2 cents on each $100 of actual value or fraction thereof: *Provided*, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which stock certificates are not actually sold, nor upon such stock certificates so deposited: *Provided further*, That the tax shall not be imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts: *Provided further*, That in case of sale where the evidence of transfer is shown only by the books of the company the stamp shall be placed upon such books; and where the change of ownership is by transfer of the certificate the stamp shall be placed upon the certificate; and in cases of an agreement to sell or where the transfer is by delivery of the certificate assigned in blank there shall be made and delivered by the seller to the buyer a bill or memorandum of such sale, to which the stamp shall be affixed; and every bill or memorandum of sale or agreement to sell before mentioned shall show the date thereof, the name of the

seller, the amount of the sale, and the matter or thing to which it refers. Any person or persons liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person or persons who shall make any such sale, or who shall in pursuance of any such sale deliver any stock or evidence of the sale of any stock or bill or memorandum thereof, as herein required, without having the proper stamps affixed thereto with intent to evade the foregoing provisions shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000, or be imprisoned not more than six months, or both, at the discretion of the court.

The corresponding provision of the Revenue Act of 1918 is not set forth as it is conceded that, for the purposes of this case, it was in all respects similar.

## ARGUMENT

### I

### Both the borrowing and the returning of the stock are taxable transfers within the meaning of the statute

It must be remembered that we are now considering only transactions conducted in accordance with the rules of the Stock Exchange. We are not concerned about a transaction where one sells stock to be delivered at a future date where, perhaps, the seller owns or controls the stock in a distant city, and requires time to procure and deliver it. Such

sales are well known and are frequently made upon the Exchange. For instance, one broker may sell stock to be delivered within 30 days. Such a transaction is known as a sale "seller 30." In such a case no borrowing is necessary. None of the transactions involved in this case was of that kind. They involved sales made in the "regular way," which, by the rules of the Exchange, must be consummated by delivery on the next business day. Let us take the case of the simplest form of a short sale. Supposing a broker sells in the forenoon 100 shares of stock which he does not have. He may buy that stock in at any time before the market closes. The person from whom he buys will deliver it to him the next day, and he in turn will deliver it to the person to whom he sold.

This transaction will involve the payment of but two stamp taxes, one upon the purchase and one upon the sale; but if he allows the market to close without "covering" his sale by purchase the rules of the Exchange require him to obtain that stock in some other way in order to deliver it. Therefore, he resorts to the practice of borrowing. He subjects himself to the inevitable disadvantage of a man who sells something that he does not have. The fact that before the transaction is completed there must be the payment of four stamp taxes is not the fault of the law but is the logical result of the operation upon the transaction of the rules of the Exchange. When the market closes and he has not "covered" his sale by purchase, which would have completed

the transaction, he must borrow the stock and subsequently buy it and return it; that is, in addition to the ordinary purchase and sale, he has entered into another contract, viz, to borrow and return four transactions instead of two, and each involving the transfer of the title to a certificate of stock, and each transfer of title the law taxes.

It would be difficult to find language more inclusive than that of the Act under consideration. The tax is upon all—

> * * * sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock * * * whether made upon or shown by the books of the * * * corporation, or by any assignment in blank or by any delivery or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock or not.

It is to be observed that this language imposes the tax upon the sale or transfer of the certificates, the pieces of paper themselves, not merely upon the transfer of the interest represented by a certificate; and it goes still further, for it imposes the tax upon the memoranda of sales, or deliveries of, or transfers of legal title to the certificates. When a lending broker delivers to a borrower a certificate of stock indorsed in blank, which the broker receiving it can then use in any way or for any purpose according to his desires or necessities, it would seem clear that a delivery of, or a

transfer of legal title to that particular certificate was complete, just as complete as would be the transfer of the legal title to a ten-dollar bill which one man hands to another as a loan. The broker who receives the certificate can use it to complete a sale which he has made, which is the normal purpose of the borrowing, or he might in turn loan it to another broker. He might take it to the transfer office and have it put in his own name. The person to whom he sells it or loans it could also have it transferred in his own name and could then put it in the safe-deposit box and it would be out of the market. The moment that the certificate indorsed in blank is delivered and the loaning broker receives a check for the full market value thereof, all his right, title, or interest in, lien upon, or control over that particular stock certificate has forever passed. No finely spun web of theory, no refinement of sophistry can change that fact. Any other hypothesis would be wholly subversive of the underlying purpose of the transaction.

When we consider the practical operations of the Exchange where, as found by the Court of Claims (26th Finding, Rec. p. 11), these transactions are evidenced by "sales tickets," "loan tickets," and "borrowed stock return tickets," and the actual delivery of the certificates themselves is through the Exchange Clearing House, this becomes even more obvious.

What this means is that each broker turns into the clearing house a daily sheet showing his transactions, the names of the brokers to whom he is to

deliver stock and the amount thereof, and the names of the brokers from whom he is to receive stock, and many other details. These sheets must, of course, agree, and it is the function of the Exchange to receive from each broker obligated to deliver and to distribute among those entitled to receive.

(For a discussion of the complicated operations of the clearing house, see "Wall Street Accounting," ch. 11, by Frederick S. Todman, M. C. S., C. P. A., The Ronald Press, 1921.)

In other words, there is a complete transfer of title to all the certificates, and the clearing house distributes them in the proper amounts to such persons as may be entitled to receive them. That the transfer of certificates in connection with the borrowing and lending necessary to complete short sales was a transfer of a legal title was the basis of the opinion of the Attorney General. (31 Ops. Atty. Gen'l. 255.) In that opinion at page 257, Acting Attorney General Davis said:

> 1. The act by its express terms, it will be observed, covers every transfer of the legal title to shares of stock with certain specific exceptions. There can certainly be no doubt that there is a transfer of the legal title from the lender to the borrower and later from the borrower to the lender under the circumstances stated. Shares of stock are fungible things, and their loan with an agreement to return things of the same class is the mutuum of Roman law, as to which no one can doubt that title passed from the lender to the bor-

rower and vice versa. (Jones on Pledges, page 64; Story on Bailments, 7th ed., sections 283, 284; Kent's Commentaries, 12th ed., Vol. II, p. 573; *Hurd* v. *West*, 7 Cowen (N. Y.) 752, 756). Even if the article be mingled with others of the same species in a warehouse, title may pass to the warehouseman. (Kent's Commentaries, 12th ed., Vol. II, p. 590, Justice Holmes's note; *South Australian Ins. Co.* v. *Randell*, L. R., 3 Privy Council Appeals 101; *Rahilly* v. *Wilson*, 3 Dillon 420.) Upon the same principle title to deposits in bank passes to the banker. (*Foley* v. *Hill*, 2 House of Lords Cas. 28.) The Supreme Court has had occasion to pass upon this characteristic of shares of stock in several cases. (*Richardson* v. *Shaw*, 209 U. S. 365; *Sexton* v. *Kessler*, 225 U. S. 90; *Gorman* v. *Littlefield*, 229 U. S. 19, 23; *National City Bank* v. *Hotchkiss*, 231 U. S. 50; *Duel* v. *Hollins*, 241 U. S. 523; and see as to bonds *United States and Mex. T. Co.* v. *Kansas City, M. & O. Ry. Co.*, 240 Fed. 505.) In *Gorman* v. *Littlefield*, the court held:

"* * * that a certificate for the same number of shares represented precisely the same kind and value of property as another certificate for a like number of shares in the same corporation; that the return of a different certificate or the substitution of one certificate for another made no material change in the property right of the customer; that such shares were unlike distinct articles of personal property, differing in kind or value, as a horse, wagon, or harness, and that stock has no earmark which distinguishes one share from an-

> other, but is like grain of a uniform quality in an elevator, one bushel being of the same kind and value as another. * * *."

The agreement between the borrowing and lending brokers, imposed by the rules of the Exchange, casts no doubt upon this conclusion. The agreement is wholly personal to the two brokers. They do it in their own names; the names of their customers do not appear in the transactions, although of course each broker keeps an account upon his own books with the customer for whom the transactions are made. (17th Finding, p. 8.)

## II

### The transactions are not to be regarded as collateral loans

An attempt is made in appellants' brief to consider the transaction as in effect a collateral loan, in which the borrowing broker loans money to the lending broker upon the security of the stock borrowed. While it is true that one broker receives cash and the other receives stock, and in a sense each is security for the other, in its essential character it is almost as far removed as possible from the ordinary collateral loan. No one ever borrows money from a bank "flat," that is, without interest; and no bank ever pays a premium to the borrower for the sake of obtaining his collateral. No bank ever receives collateral for loans for the express purpose of selling it the next day, and no man ever delivered his securities to a bank with the idea that the bank

was going to make way with them the next day for its own benefit. The transaction is, of course, peculiar to this particular kind of business, and very little light is thrown upon its inherent character by analogies drawn from the common law of years long past, like the loaning of a wheelbarrow or a bushel of grain.

As the Attorney General says, 31 Opinions 259:

> A loan of stock can not be called a pledge thereof within the meaning of the first proviso. The transaction is, in effect, the reverse of that covered by the proviso. In the latter case, *money is loaned*, and *stock is* deposited as *collateral* for its return. In the case now in question *stock is loaned* and *money is* deposited as *collateral* for its return. In one case the debt is money, in the other stock.

The record in the court below confirms this conclusion. In the petition filed in the Court of Claims, paragraph 6, subdivision (b), Record, page 2, it is alleged:

> The borrowing broker deposits with the lending broker *as security* when the loan of the stock is made *the full market price of the stock.*

The facts found by the Court of Claims were stipulated by the parties (Rec. p. 5), and in the tenth finding thus stipulated (p. 7) the court finds:

> When the loan of stock is made, the borrower borrowing the stock *deposits* the *full market price of the stock* with the broker lending the stock *as security.*

While the transaction has in it elements of advantage to both sides, undoubtedly, nevertheless it is clear that it is the necessity of the borrower which initiates the transaction; for, as found by the Court of Claims (25th Finding, subparagraph (g), p. 11), the borrowing broker repays to the lending broker the cost of stamps affixed by the lending broker to the loan tickets, and in turn charges the amount so paid to the account of his customer, and the borrowing broker also charges to his customers' accounts the cost of stamps affixed to the borrowed stock return tickets; that is, the speculator, who trades on the short side of the market, pays for both sets of stamps; the transaction is for his benefit, and he has to bear the cost.

Clearly these transactions are not within the proviso exempting collateral loans from the tax.

## III

### Legislative History

The Revenue Act of 1918 reenacted the provision of the Act of 1917 without change material to this controversy. (Act of February 24, 1919, c. 18, 40 Stats. 1057; Title XI, Schedule A, Par. 4, 40 Stats. 1135.)

When the bill which became the Act of 1918 was pending, Mr. T. B. Maloney, a member of the Consolidated Exchange of New York City, appeared before the Senate Committee on Finance on September 11, 1918, called attention to the ruling of the Treasury Department of March 30, 1918, and the

opinion of the Attorney General dated March 23, 1918, and urged that the law be changed so as to exempt "borrowing" transactions from the tax. (Hearings before the Committee on Finance, United States Senate, 65th Congress, 2d sess., H. R. 12863, p. 196 *et seq.*) Mr. Maloney submitted a copy of the Attorney General's opinion and filed a brief on behalf of the Consolidated Exchange. The following occurred at the hearing:

> Senator PENROSE. Have you prepared any amendment to cover the phraseology?
>
> Mr. MALONEY. Yes, sir; I can cover it in about four words which the New York statute has.
>
> Senator PENROSE. Get that into the record.
>
> Mr. MALONEY. It is in this brief.
>
> Senator PENROSE. Get it into the record so that we will have a note of it.
>
> Mr. MALONEY. We suggest that it be amended by using the following words: "nor upon mere loans of stock or the return thereof."
>
> Senator PENROSE. Where would you put that in?
>
> Mr. MALONEY. That would go in paragraph 4, after the words "deliver or transfer for such purpose of certificates so deposited."

The suggested change, however, was not made in the Bill as passed. In the Revenue Act of November 23, 1921, c. 136, 42 Stats. 227, Mr. Maloney's suggestion was adopted (Title XI, Schedule A, Par. 3) by inserting at the end of the first proviso, at the place suggested by Mr. Maloney, the words, "nor

upon mere loans of stock nor upon the return of stock so loaned." (42 Stats. 304.)

No persuasive argument can be drawn from the fact that under previous revenue acts the Treasury did not attempt to impose a stamp tax upon these transactions. Neither the law of 1898 (30 Stats. 448, 458) nor the Act of 1914 (38 Stats. 759), which are quoted on pages 19 and 20 of appellants' brief, contain the phrase in the Acts of 1917 and 1918, "or transfers of legal title to shares or certificates." The ruling of the Treasury Department, set forth on pages 21 and 22 of appellants' brief, was under the 1914 law, and in the hypothetical case stated, which brought forth the ruling, it was said: "This transfer does not represent a change of ownership."

In appellants' brief (p. 44) it is contended:

> There is nothing to indicate that Congress was cognizant of this custom or intended to tax such transaction.

With equal force it may be argued that the chances are that the Treasury officials were not cognizant of the mechanics of borrowing stock during the years in which the 1898 and 1914 laws were in effect, even though the language of those Acts might be susceptible of construction which would justify the tax. When, however, after the passage of the Act of 1917 the question arose in a formal manner and was submitted to the Attorney General for his opinion the situation changed. The Treasury ruling and the Attorney General's opinion were formally placed be-

fore Congress, and Congress declined to change the appropriate provisions when they enacted the Revenue Act of 1918. The inference is plain that Congress was satisfied with the existing law as interpreted by the Attorney General. *United States* v. *Falk & Brother*, 204 U. S. 143. Under these circumstances when the Act of 1921 was under consideration and Congress adopted the suggestion which had been urged by the brokers in 1918, the inference must be that Congress then for the first time intended to change the law. *Smietanka* v. *First Trust & Savings Bank*, 257 U. S. 602.

CONCLUSION

The judgment should be affirmed.

WILLIAM D. MITCHELL,
*Solicitor General.*

ALFRED A. WHEAT,
*Special Assistant to the Attorney General.*

NOVEMBER 7, 1925.

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